STATE OF NEW YORK

DIVISION OF TAX APPEALS

In the Matter of the Petition of **THE HUMPHREY HOUSE, INC.** for Revision of a Determination or for Refund of Sales and Use Taxes under Articles 28 and 29 of the Tax Law for the Period December 1, 1987 through November 30, 1990.	DETERMINATION DTA NO. 813375 AND 813376
In the Matter of the Petition of **WILLIAM A. GLEASON, OFFICER OF THE HUMPHREY HOUSE, INC.** for Revision of a Determination or for Refund of Sales and Use Taxes under Articles 28 and 29 of the Tax Law for the Period December 1, 1987 through November 30, 1990.	

Petitioners, The Humphrey House, Inc., 1783 Penfield Road, Penfield, New York 14626, and William Gleason, 833 Whalen Road, Penfield, New York 14526, filed separate petitions for revision of determinations or for refund of sales and use taxes under Articles 28 and 29 of the Tax Law for the period December 1, 1987 through November 30, 1990.

A consolidated hearing was held before Marilyn Mann Faulkner, Administrative Law Judge, at the offices of the Division of Tax Appeals, Riverfront Professional Tower, 500 Federal Street, Troy, New York, on October 10, 1995 at 9:30 A.M., with all briefs due by February 7, 1996. Petitioners, represented by Bansbach, Zoghlin, Asandrov & Wicks, P.C. (Louis V. Asandrov, Esq., of counsel) filed a brief on December 14, 1995. The Division of Taxation, represented by Steven U. Teitelbaum, Esq. (Brian J.McCann, Esq., of counsel), filed a brief on January 18, 1996. Petitioners filed a reply brief on February 7, 1996, which date commenced the six-month period for issuance of this determination.

ISSUE

I. Whether petitioners' records were inadequate for purposes of conducting a complete and accurate audit.

II. Whether there was sufficient evidence to allow the trier of fact to determine the audit had a rational basis.

III. Whether the method selected by the Division of Taxation for calculating the percentage food markup and estimating petitioners' sales tax liability was reasonable.

IV. Whether petitioners met their burden of proving that adjustments were required in estimating sales tax with respect to portion sizes, free hors d'oeuvres, Christmas gifts, employee meals and steward sales.

V. Whether petitioners' reading of the conciliation orders is correct that the amount of tax specified is inclusive of penalty and interest.

VI. Whether there is reasonable cause to warrant cancellation of the penalty.

FINDINGS OF FACT

1. Petitioner, The Humphrey House, Inc., is a family-styled restaurant that serves lunch and dinner. The restaurant also has a bar where the owner provides free buffet-style food on Sunday afternoons and during certain sporting events that are televised.

2. The stock in the restaurant was owned equally by Jonathan Ludwig and William Gleason until January of 1990, at which time Mr. Gleason sold his 50 shares of common stock to Mr. Ludwig for $25,000.00. Fifteen thousand dollars of the total sale price was allocated to Mr. Gleason's agreement to a covenant not to compete for three years.

3. The Division of Taxation ("Division") commenced an audit of the restaurant in July of 1990. Initially, the audit was assigned to Thomas Heagerty who sent an appointment letter, dated October 10, 1990, to The Humphrey House requesting an appointment to see the books and records of the restaurant including all journals, ledgers, sales invoices, purchase invoices,

and cash register tapes for the period September 1, 1987 through August 31, 1990. Petitioner[1] provided the auditor with sales tax returns, related worksheets for the sales tax returns, Federal and State income tax returns and related worksheets, a sales journal, and a purchase journal for the audit period. However, petitioner did not provide guest checks or cash register receipts. Mr. Ludwig informed the auditor that guest checks and cash register receipts were kept for a month or two and then discarded. Petitioner's accountant, Daniel Tessoni, testified that the accounting system he put into effect at the restaurant required petitioner to record on daily sheets the food, beer and liquor sales, sales tax, and cash paid out for miscellaneous payments from the cash drawer, and to reconcile those amounts with the daily deposits. Those daily sheets were made available to the auditors during the course of the audit.

4. Because the guest checks and cash register receipts were not available to the auditor, the Division decided to estimate the sales tax due by performing a mark up of purchase invoices. For that purpose, the Division asked petitioner to keep all guest checks and cash register receipts for January 1991. Two other Division auditors assigned to this audit, Andrew Kucharski and Scott Callahan, collected information from the business and summarized the guest checks for the month of January of 1991 to determine how many lunches versus dinners were sold to arrive at an average price for certain food items. The auditors averaged the prices for a particular food item because the price differed depending on whether the item was sold for lunch or dinner.

5. Initially, the Division calculated the markup on food to be 241%. According to an entry on the audit report on July 26, 1991, this markup was based on discussions Mr. Kucharski and Mr. Heagerty had with the "owner, cook, [and] CPA" concerning food portions. The Division compared this percentage markup with the 273% markup contained in a publication of the National Restaurant Association (Restaurant Industry Operations Report, 1988) concerning the industry average for a medium restaurant.

---

[1]References to petitioner in this determination is to the restaurant, The Humphrey House, unless otherwise indicated.

6. At some point in the course of the audit, Mr. Heagerty was reassigned within the audit unit and Donald Dahlgren was assigned as the supervising auditor. After numerous discussions with Mr. Ludwig and his accountant, the first of which took place in January of 1992, and after petitioner provided additional documentation, the Division made some allowances for portion sizes, shrinkage, spoilage, theft and free hors d'oeuvres. The Division did not accept petitioner's request for allowances with respect to employee meals and steward sales.[2] Petitioner also disagreed with the Division's portion size with respect to chicken as well as shrinkage and portions with respect to other food items.

7. Mr. Dahlgren prepared a worksheet based on his analysis of the information provided by the other auditors. The worksheet listed the purchase invoices for January of 1991 of certain main food items such as Alaskan King Crab, haddock, clams, scallops, shrimp, sole, lobster tails, prime rib, veal, chicken, halibut, swordfish, steak, hamburger, lamb chops, pork chops, duck, ham, corned beef, pastrami, turkey and tuna. The worksheet also contained the cost and quantity of these food items according to the purchase invoices, an allowance for waste depending on the food item, the number of servings and average menu price. Using this information, Mr. Dahlgren calculated the marked-up price for each of those food items by multiplying the number of portions by the average menu price. He totaled these amounts and divided them by the total purchase prices for those particular food items, and other miscellaneous food items such as fruits, vegetables and cheeses contained in the purchase invoices, to arrive at a markup of 193.18%. At hearing, Mr. Dahlgren testified that petitioner's records reflected a markup of 160%. It was unclear what records he was referring to or on what basis the 160% was computed.

8. The Division had Mr. Ludwig fill out a bar tax sheet and bar questionnaire listing the prices and ounces of the beer and liquor served. Applying that information to the actual purchases of beer and liquor for the quarter ending August 1990, the Division computed a 317% markup on beer and a 332% markup on liquor. Because the Division calculated the audited

[2]Petitioner claims that it made steward sales, that is, sales at cost of unprepared food to various organizations, customers and relatives of Mr. Ludwig.

beer and liquor sales to be $87,579.00 and the sales reported for the test quarter were $87,212.00, it decided to accept the beer and liquor sales as reported by petitioner for the audit period.

9. The Division applied the 193.18% markup to petitioner's food purchases from May 1, 1986 through April 30, 1989, less purchases of non-food items that had been mistakenly posted to food, and less allowances for theft and free hors d'oeuvres, to estimate food sales. Mr. Dahlgren then added the reported beverage sales for the same three-year period and subtracted the total reported food and beverage sales to calculate additional sales. These additional sales were then divided by the total reported sales for the same three-year period to compute the error percentage of gross sales at 0.117058. The error percentage was then applied to the gross sales reported for the audit period from December 1, 1987 through November 30, 1990, resulting in additional sales tax due of $22,007.65. Mr. Dahlgren explained in his testimony that he used beverage sales in that calculation, even though he accepted petitioner's beverage sales as reported, because he was using petitioner's sales tax returns, which did not break down the beverage and food sales, for the reported sales. He also noted that he used the food purchases for the three-year period in calculating the error percentage, even though eleven months of that three-year period fell outside the audit period, because that information was available to him at that time and he did not want to delay the audit any further. Mr. Dahlgren also stated that he felt that the larger period of time used in his calculations was more representative. During cross examination, Mr. Dahlgren testified as follows:

> "Q. . . . .to compute the error rate on these schedules -- that didn't fully go through the audit period, you only had a portion of the audit period?
>
> A. Again, the periods I had information for were 5/1/86 through 4/30/89. The audit period went to November of 1990, but the last quarter dropped off.
>
> Q. Why was that information missing, because that is what Mr. Heagerty filed?
>
> A. Mr. Heagerty filed only information from 4/30/87, 4/30/88 and 4/30/89.
>
> Q. Was there any indication the period subsequent to 4/30/89 was missing?
>
> A. No, it wasn't missing. No, he just didn't write down the numbers.

Q. Why didn't he?

A. I don't know. I would have rather used that information in fact. Once we got that information, the audit findings, BCMS came within a hundred dollars of what I did.

Q. Well, you would have rather used that information?

A. Yes. That was never an issue in any of the conversations we had. I told both of those gentlemen if there is something flawed in any way that I did, show me." (Tr., pp 81-82).

10. On January 19, 1993, Mr. Dahlgren met with petitioner's representatives, David Veniskey and Ellen Williams, both of whom are certified public accountants, to discuss a settlement option. Mr. Dahlgren requested petitioner to submit a letter to waive the penalties and proposed the possibility of waiving the penalties and changing the chicken portions from one piece to one-and-a-half pieces in calculating the percentage markup. These proposed adjustments would have reduced the overall tax due from $40,206.53 to $15,829. Petitioner did not agree to this proposal. Using its own portion sizes and the Division's methodology in calculating the percentage markup, petitioner recalculated the food markup to be 168.63% (Pet.'s Exhibit 5). During the course of these discussions, petitioner asserted that steward sales in the amount of $400.00 per month or $14,400.00 for the 36-month period should be subtracted from the purchases. Petitioner also claimed that employee meals cost petitioner between 10 to 12 dollars a day or roughly $325.00 per month or $11,700.00 for the 36-month audit period.

11. The Division issued to The Humphrey House a Notice of Determination, dated March 1, 1993, and to William Gleason a Notice of Determination, dated March 1, 1993, for sales tax due for the period December 1, 1987 through November 30, 1990 in the amount of $22,007.64, plus interest in the amount of $11,940.77 and a $6,602.30 penalty, for the total amount of $40,550.71.

12. Petitioners requested a conciliation conference from the Bureau of Conciliation and Mediation Services ("BCMS"). After a conference was held on December 8, 1993, the conferee requested, in a letter dated February 1, 1994, that petitioner provide him with a breakdown

between beverage sales and food sales by quarter for the audit period and food purchases by quarter for the entire audit period. The conferee indicated that this request was a follow up on his inquiry at the conference as to why the Division included beverage sales in its application of the error rate when it determined that no additional tax was due with respect to beverage sales. By letter dated April 29, 1994, the conferee stated that because petitioner did not submit additional documentation to support its claimed allowances for shrinkage, steward sales, Christmas gifts and employee meals, there was no basis to grant further allowances other than in the area of free hors d'oeuvres. According to the conferee, because the Division accepted petitioner's original adjustment for hors d'oeuvres, the conferee was accepting petitioner's subsequent increase in that adjustment to $7,800.00 per year, thereby increasing the adjustment to $23,400.00 for the entire 3-year period. Therefore, based on that adjustment the conferee proposed reducing the tax from $22,007.64 to $19,943.77, plus penalty and interest, conditioned on petitioner's consent to that amount.

13. By letter dated August 3, 1994, the conferee proposed a further reduction of the tax. Based on information provided by petitioner - namely, the breakdown of food and beverage sales and purchases for the entire audit period - the tax was recomputed based on this additional information in response to petitioner's objections that the Division included the beverage sales in applying the error rate and used purchase and sales figures outside the audit period. However, the conferee noted that a recomputation of the error rate, excluding beverage sales or excluding food sales outside the audit period and using only food sales for the actual audit period, resulted in a higher error rate. Similarly, the conferee noted that a recomputation applying the markup percentage to the food purchases from the audit period and comparing it with the reported food sales from the actual audit period resulted in additional tax due of $55.93. The conferee therefore concluded that a comparison of the purchase and sales figures for the actual audit period with those figures utilized by the Division, which included figures outside the audit period, "indicated no detrimental affect on the tax liability". He further opined that the audit method used by the Division had a rational basis and that it reasonably calculated

the tax liability "given the information available at hand". The conferee cancelled the sales tax for the last quarter ending November 30, 1990, however, because there was no evidence that the Division requested petitioner's books and records for that period. The conferee found no basis for any further allowances for Christmas gifts, employee meals, steward sales, shrinkage or hors d'oeuvres because petitioner had not submitted any documentation to substantiate its claims. However, the conferee proposed, for the purpose of resolving the dispute, that the Division's 193.18% markup be averaged with petitioner's 168.63% markup resulting in a revised tax due of $12,504.10. Therefore, subject to petitioner's signing of a consent agreement, the conferee offered a reduction of the tax to $12,504.10, plus cancellation of the penalty and a reduction of interest to the minimum statutory interest. Petitioner did not consent to this proposed reduction.

14. The BCMS conferee issued to The Humphrey House a conciliation order, dated September 2, 1994, recomputing the statutory notice by cancelling only the sales tax for the last quarter ending November 30, 1990. The tax due was $20,090.65. Next to the entries for penalty and interest are the words "computed at applicable rate." The conferee also issued to William A. Gleason a conciliation order, dated September 2, 1994, recomputing the statutory notice by cancelling the tax for the period after December 31, 1989 inasmuch as the sales agreement indicated that Mr. Gleason sold his interest in the business in January of 1990. The tax due was $15,204.15 with penalty and interest computed at the applicable rate.

15. Petitioners each filed a petition dated December 1, 1994. In their petition, petitioners argued that adequate records were available to perform an audit, and therefore, the Division should not have used a markup of purchases to estimate the tax due; that the method used to estimate the sales tax liability was arbitrary and capricious because the auditor used records outside the audit period and included beverage sales in applying the error rate when no addition tax was due for the bar sales; and that because the initial audit was fundamentally devoid of rationality, it was not necessary for the taxpayer to prove the exact amount of the over assessment. Petitioner, William Gleason, did not challenge the Division's determination that he was a person responsible for the collection of sales tax.

16. The Division filed two answers, dated March 8, 1995, to each petition affirmatively stating, inter alia, that the use of a markup audit was proper because petitioner did not maintain any source records for the period at issue, and that the use of sales figures outside the audit period to determine a markup percentage was not irrational.

17. At the hearing held on October 10, 1995, the Division submitted into evidence work papers recomputing petitioner's sales tax based on the breakdown of food and beverage sales for the audit period and the food purchases by quarter for the audit period that petitioner had provided to the BCMS conferee. In those work papers, the auditor made allowances for non-food items and theft of food purchases, as requested by petitioner, and hors d'oeuvres, in the respective amounts of $33,851.68, $9,700.49 and $9,100.00.[3]

The Division calculated the taxable food sales per quarter and set forth these calculations in its Exhibit "O". The taxable food sales for the last quarter and for the entire audit period were calculated as follows:

Audit Period	Purchases per books	Adjustments to purchases	Purchases after adjustments	Markup per audit	Taxable Food sales per audit
9/1/90-11/30/90	$ 83,596.04	$ 4,384.97	$ 79,211.07	$193.18	$ 153,019.95
12/87-11/90	1,003,900.55	52,652.17	951,248.38	193.18	1,837,621.62

The Division then subtracted the reported sales per petitioner's books to calculate the sales tax due for the last quarter of the audit period and the entire audit period as follows:

Audit Period	Taxable Food Sales per audit	Additional Taxable Food Sales per books	Taxable Food Sales per audit	Additional Tax Rate	Tax due per audit

[3]During discussions with petitioner's representatives, petitioner claimed that the cost for free hors d'oeuvres amounted to $9,100.00 for the three-year period. Petitioner then claimed that his invoices showed that the cost for the free hors d'oeuvres amounted to $10,500.00 for the three-year period. Petitioner presented no substantiation to support this claim or the claim, referred to in the BCMS conferee's proposed settlement of April 29, 1994, that free hors d'oeuvres amounted to $7,800.00 per year.

9/1/90 - 11/30/90	$ 153,019.95	$ 135,847.30	$ 17,172.65	0.07	$ 1,202.09
12/87 - 11/90	1,837,621.62	1,529,190.50	308,431.12	0.07	21,590.18

18. At hearing, Mr. Ludwig testified that employee meals were provided at the average cost of three dollars a day per employee. He also stated that he employed approximately 30 employees and he gave Christmas gifts, such as boxes of shrimp, strip loin or prime rib, to his employees amounting to approximately $2,000.00 every year. He further testified that he sold food items at cost to certain family members and customers that "probably" averaged $500.00 or $600.00 a month. When questioned about how long he would keep his food inventory, Mr. Ludwig testified as follows:

> ALJ: In terms of your inventory, Mr. Tessoni mentions sometimes the inventory would stay longer than usual because you would get a sale on some items and get more and put it in the freezer.
>
> Mr. Ludwig: Right. That specific month I bought twenty cases of king crab legs that cost me $4,000.00, because it was cheap and it only lasted me three months.
>
> ALJ: That would last you three months?
>
> Mr. Ludwig: Right.
>
> ALJ: How much did you use that January?
>
> Mr. Ludwig: Not very much because I wasn't very busy in January. (Tr., p.183).

19. During the course of the hearing, petitioner was granted the opportunity to submit post-hearing affidavits in support of its claims concerning adjustments to food purchases for free hors d'oeuvres, employee meals and steward sales.

20. At the close of the hearing, the Administrative Law Judge stated that no further documents would be accepted after the close of the hearing on October 10, 1995, with the exception of the affidavits to be submitted in support of petitioner's claims with respect to free hors d'oeuvres, employee meals and steward sales.

21. Petitioner submitted fifteen post-hearing affidavits, thirteen of which were from individuals and two of which were submitted on behalf of Camp Haccamo and the Penfield Fire Department, stating that the affiants purchased a certain amount of unprepared food at cost from

Mr. Ludwig on an annual basis. The amount of these steward sales claimed on an annual basis totaled $14,686.50. With the exception of the affidavit of Kenneth R. Fisher, none of these affidavits specified a time period for these annual food sales at cost. Kenneth Fisher stated in his affidavit that based on a review of his records, he purchased $526.50 worth of food at cost from Mr. Ludwig in 1989 and continued to purchase approximately this amount on a yearly basis since 1989.

22. Petitioner submitted 103 post-hearing affidavits from customers stating that petitioner provided free buffet-style food on Sunday afternoons and on several occasions throughout the year. Again, these affidavits do not specify a time period for the free buffet-styled events or indicate the quantity of food provided.

23. Petitioner also submitted 13 post-hearing affidavits of employees stating that petitioner supplies employees with meals at each shift if the shift totaled 3 hours or more. With the exception of three affiants, all the employees commenced employment with petitioner prior to, or during, the audit period.

24. Along with the above post-hearing affidavits submitted on November 10, 1995, petitioner also submitted a post-hearing affidavit of Mr. Ludwig and a post-hearing affidavit of Ellen Williams, a certified public accountant who worked with Mr. Ludwig in preparing workpapers concerning requested adjustments from the Division.

SUMMARY OF THE PARTIES' POSITIONS

25. Petitioner argues that the absence of guest checks and register tapes did not amount to inadequate records; that the Division's use of information outside the audit period renders the methodology inherently irrational and therefore the assessment should be cancelled; that the inclusion of beverage sales in the calculation of the tax was arbitrary; that the reported sales in January of 1991 indicated a food markup of 163% and not the estimated 193.18% computed by the Division; that a proper reading of the $20,090.65 tax due in the conciliation order includes interest and penalty; that the auditor, Mr. Dahlgren, was deceitful and dishonest, was furtive in his responses at hearing and even lied and perjured himself; and that the audit was "typified by

novice, ill-trained and ill-equipped auditors, who used Petitioner and his business for practical learning experience in conducting a first impression, guinea-pig audit" (Pet. Brf., p. 16).

26. The Division argues that petitioner's post-hearing submission of the affidavits of John Ludwig and Ellen Williams was improper because they fell outside the limited permission granted for the submission of post-hearing affidavits, and constitute an attempt to add to John Ludwig's testimony and to add the testimony of Ellen Williams without the scrutiny of cross examination. The Division contends that petitioner's records were inadequate because there were no source documents to verify petitioner's sales; that the Division was justified in using an indirect audit method and reasonably calculated the tax due based on the information made available to it during the actual audit; that petitioner's have not shown how the Division's use of information outside the audit period, and the use of beverage sales to determine the error rate, were unreasonable and prejudicial; that petitioner's has presented no evidence justifying any changes to the waste and spoilage allowances permitted in the Division's calculations; that the affidavits in support of steward sales should be rejected as unreliable; that petitioner's evidence concerning an allowance for employee meals should be rejected inasmuch as 20 NYCRR 527.8(j) provides that such meals constitute taxable sales unless they are included in remuneration for FICA and unemployment insurance purposes.

CONCLUSIONS OF LAW

A. Under Tax Law § 1135(a), "[e]very person required to collect tax shall keep records of every sale . . . in such form as the commissioner of taxation and finance may by regulation require." These records must be kept in a manner suitable to determine the correct amount of tax due and must be available for the Division's inspection upon request (Tax Law § 1135[d]; 20 NYCRR 533.2[a][2]). The regulations provide that among the sales records required to be maintained are "sales slip, invoice, receipt, contract, statement or other memorandum of sale, . . . guest check, . . . cash register tape and any other original sales document" (20 NYCRR 533.2[b][1]).

In this case, petitioner did not produce any guest checks, cash register tapes or any other original sales document to verify the amount of sales for the period in question. The Division was not required to accept petitioner's daily sheets as evidence for the accuracy of petitioner's sales tax returns because these daily sheets could not be verified by source documents such as guest checks or cash register tapes (see, Matter of Goldner v. State Tax Commission, 70 AD2d 978, 418 NYS2d 477, lv. denied 48 NY2d 608, 423 NYS2d 1025). Thus, contrary to petitioner's claim, petitioner's records were inadequate for purposes of conducting a complete and accurate audit.

B. When the taxpayer's records are incomplete and unreliable for determining accurate sales, the Division may resort to a test-period audit using external indices such as purchases in determining percentage markups (Matter of Skiadas v. State Tax Commission, 95 AD2d 971, 464 NYS2d 304, 305; Matter of Urban Liquors, Inc. v. State Tax Commission, 90 AD2d 576, 456 NYS2d 138, 139; Matter of Hanratty's/732 Amsterdam Tavern, Inc. v. New York State Tax Commission, 88 AD2d 1028, 451 NYS2d 900, 902, lv. denied 57 NY2d 608; Matter of Korba v. New York State Tax Commission, 84 AD2d 655, 444 NYS2d 312, 314, lv denied 56 NY2d 502, 450 NYS2d 1023). In determining the adequacy of the records, the Division must first request the records (Matter of Christ Cella v. State Tax Commission, 102 AD2d 352, 477 NYS2d 858, 859) and thoroughly examine the records presented (Matter of King Crab Restaurant v. Chu, 134 AD2d 51, 522 NY2d 978, 979-980) for the audit period in question (Matter of Adamides v. Chu, 134 AD2d 776, 521 NYS2d 826, 828, lv denied 71 NY2d 806, 503 NY2d 109). In this case, the auditor did not request the records for the quarter ending November 30, 1990, therefore, the conferee was correct to cancel the tax with respect to that quarter (see, Matter of Adamides v. Chu, supra).

C. When conducting the audit, the Division must select a method reasonably calculated to reflect the tax due (Matter of Urban Liquors, Inc. v. State Tax Commission, supra at 139, citing Matter of Grant Co. v. Joseph, 2 NY2d 196, 206, 159 NYS2d 150, cert denied 355 US 869). Because the Division is using external indices to estimate the tax, exactness in the

outcome of the audit is not required (Matter of Markowitz v. State Tax Commission, 54 AD2d 1023, 388 NYS2d 176, 177, affd 44 NY2d 684, 405 NYS2d 454; Matter of Lefkowitz, Tax Appeals Tribunal, May 3, 1990). However, the record must contain sufficient evidence to allow the trier of fact to determine whether the audit had a rational basis (Matter of Basileo, Tax Appeals Tribunal, May 9, 1991, citing Matter of Grecian Square v. New York State Tax Commission, 119 AD2d 948, 501 NYS2d 219, 221; see, Matter of Fokos Lounge, Tax Appeals Tribunal, March 7, 1991; Matter of Fortunato, Tax Appeals Tribunal, February 22, 1990). Once this threshold determination is made, the burden then rests on petitioner to show by clear and convincing evidence that the methodology was unreasonable or that the amount assessed was erroneous (Matter of Meskouris Bros. v. Chu, 139 AD2d 813, 526 NY2d 679; Matter of Surface Line Operators Fraternal Org. v. Tully, 85 AD2d 858, 446 NYS2d 451, 452).

In this case, petitioner claims that there was insufficient evidence to determine whether the audit methodology had a rational basis and therefore, the burden of proof had not shifted to petitioner to show that the method was unreasonable or the amount assessed was erroneous. Citing a Division of Tax Appeals Administrative Law Judge's determination in Matter of Paul Lasini's Restaurant (June 25, 1992), petitioner contends that the facts in Paul Lasini's Restaurant are similar to the facts in this case and therefore require a finding that there is insufficient evidence to support the Division's 193.18% markup. Specifically, petitioner argues that it was improper for the Division to rely on the 1988 publication of the National Restaurant Association in comparing the average markups of restaurants. Petitioner also objects to the Division's use of the 193.18% markup based upon information from January 1991 when the actual markup for that month was 163% according to the guest checks. Petitioner asserts that because sales for January 1991 indicated a 163% markup of food, there is no rational basis for the Division to estimate a higher markup based on the same information. Petitioner further asserts that there is no rational basis for the Division to accept petitioner's beer and liquor markup for the month of January 1991 and not accept petitioner's actual food markup for that same month.

Tax Law § 2010.5 provides that determinations issued by an Administrative Law Judge of the Division of Tax Appeals "shall not be considered as precedent nor be given any force or effect in any other proceedings". Therefore, the Administrative Law Judge's determination in Matter of Paul Lasini's Restaurant has no precedential value in determining the present case. In any event, the facts in Paul Lasini's Restaurant are not similar to the facts in this case. In Paul Lasini's Restaurant, the Division did not use purchases to determine a food markup, the Division instead based its markup percentage on the auditor's general experience in conducting other restaurant audits, without providing a reasonable basis for making such a comparison to these other restaurants. Moreover, in this case, although the Division preliminarily compared its initial markup with the average markups contained in the 1988 publication of the National Restaurant Association, it did not rely on those averages in calculating the final 193.18% markup. Finally, unlike the situation in the present case, the ALJ found in Paul Lasini's Restaurant that the Division improperly assumed that the prices on a bar fact sheet concerning liquor were wrong based on its determination that the separately-stated wine prices were inaccurate. In contrast, in the present case the Division properly considered the beverage and food categories separately on their own merits and did not make an assumption about one category based upon information about another category.

In sum, in contrast to petitioner's claim, there is no basis for finding that there is insufficient evidence to determine whether the audit methodology had a rational basis. The Division used information made available to it by petitioner such as purchase invoices, reported sales, menu prices, portion sizes, non-food items in the purchase invoices, waste and theft percentages and the ratio of lunch versus dinner sales for the month of January 1991 in order to determine the average price of food items sold. This is not a case where there was insufficient information in the record to determine the reliability or reasonableness of the Division's methodology (compare, Matter of Grecian Square v. New York State Tax Commission, supra).

D. Furthermore, petitioner has not demonstrated that the methodology used by the Division was unreasonable given the information it had at the time of the audit.[4] The Division was not obligated to accept petitioner's reported sales for the month of January 1991 in calculating the markup of purchases inasmuch as there is no way to verify that petitioner's record keeping in January 1991 was reflective of its record keeping during the audit period. The Division used the guest checks for the limited purpose of determining the average price of certain menu items based on how many lunches versus dinners were sold in the month of January. Moreover, petitioner does not show how it calculated the 163% markup by using the actual food sales for the month of January. In Petitioner's Exhibit 6, petitioner shows food sales for the month of January 1991 in the amount of $39,861.95. Dividing this number by the purchases ($27,585.41) used by the Division in its calculation of the 193.18% markup, results in a 144.5% markup. In any event, even if the Division had accepted the reported food sales in calculating the percentage markup, it would also have to subtract out the end inventory for that month (thereby decreasing the denominator in the equation which in turn elevates the percentage markup) in order to accurately calculate the percentage markup.[5]

E. Petitioner faults the Division for including food and beverage sales for an eleven-month period outside the audit period and beverage sales in its calculation of the error rate when the Division accepted petitioner's markup on beverage sales. Petitioner contends that the use of information outside the audit period renders the audit methodology inherently irrational.

Contrary to petitioner's basic premise, the Division may use information outside the audit period, or any other external indices, as long as there is a rational basis for its use. Inasmuch as petitioner's failure to maintain adequate records prevented exactness in the calculation of the tax due, exactness in determining the sales tax liability is not required (Matter of Meyer v. State

---

[4]Throughout its brief, petitioner accuses Mr. Dahlgren of giving furtive responses during his testimony and of lying and committing perjury. Based on my observations of Mr. Dahlgren's demeanor and responses during his testimony, I find that there is absolutely no basis for such claims.

[5]As noted above in Finding of Fact "18", Mr. Ludwig testified that in January 1991 he bought twenty cases of king crab legs for $4,000.00 that was sold over the course of the next three months, and that not very much of that inventory was actually sold in the month of January.

Tax Commission, 61 AD2d 223, 402 NYS2d 74, 78, lv denied 44 NY2d 645, 406 NYS2d 1025). A determination as to whether the Division utilized a reasonable audit methodology must be based upon what was presented to the auditor during the time of the actual audit (Matter of Northern States Contracting Co., Inc., Tax Appeals Tribunal, February 6, 1992). Given the information Mr. Dahlgren had at the time he calculated the error rate, the use of food and beverage sales from the eleven-month period outside the audit period was not unreasonable nor prejudicial to petitioner. Mr. Dahlgren used food and beverage sales for a three-year period rather than just the two-year period that fell within the audit period in order to get a larger representative period in calculating an error percentage to apply to the reported sales in the audit period. If one used the information from the two-year period only, the error rate would have been higher (0.140) than the error rate that the auditor used (0.1170580) in determining sales tax due.

Similarly, given the information the Division had at the time Mr. Dahlgren calculated the error rate and sales tax due, the inclusion of the beverage sales was reasonable and, in any event, was not prejudicial. The Division included reported beverage sales without markup in its calculation of the error rate because the sales tax returns, which the Division used for reported sales for the audit period, did not have a breakdown between beverage and food sales. After the Division obtained the breakdown of the beverage and food sales and purchases by quarter for the audit period from the conferee, it recalculated the sales tax due directly, without the use of an error percentage, by applying the percentage markup to the food purchases and computing the difference between reported food sales and food sales per markup. As noted in Finding of Fact "11" and "17", the new calculation resulted in a reduction of the tax by $417.46 ($22,007.64 - $21,590.18).

Inasmuch as the breakdown of food and beverage sales and purchases are now available, the tax liability for the period December 1, 1987 through November 30, 1990 should be reduced by the $417.46 in accordance with the Division's calculations in its Exhibit O. Furthermore, the conciliation order reduced the tax by cancelling the tax due for the last quarter ending

November 30, 1990, leaving a 33-month rather than a 36-month audit period. Using the calculations from the Division's Exhibit O, the tax should be reduced from $21,590.18 by $1,202.09 to $20,388.09 (see, Finding of Fact "17").

F. Petitioner asserts that the Division failed to make adjustments with respect to portion sizes, free hors d'oeuvres, Christmas gifts, employee meals and steward sales. When a taxpayer proves that the Division fails to take into account certain facts specifically related to petitioner's business, the appropriate remedy is to modify the audit by making certain adjustments, and not to cancel the assessment (see, Matter of Skiadas v. State Tax Commission, supra).

Petitioner claims that the portion sizes used by the Division in calculating the food markup were inaccurate and that the Division did not identify the source of its information in determining the portion sizes by identifying any cook by name. In the field audit report, the entry indicated that the portion sizes the Division used in its calculations were based on discussions with the owner, cook and CPA. The fact that the entry did not refer to the cook by name, in itself, is of no consequence. Thus, inasmuch as the field audit report is a reliable contemporaneous document, the Division has established a rational basis for using those portion sizes in its calculations thereby shifting to petitioner the burden of proving otherwise.

In support of its contention, petitioner submitted schedules with food portions, some of which were different from those used by the Division's auditor. These schedules were prepared by petitioner's accountant based on discussions with Mr. Ludwig. By themselves, these schedules constitute hearsay evidence that, although admissible, are not sufficiently probative to meet petitioner's burden of proving that the portion sizes used by the Division in its audit were inaccurate.[6] Although petitioner claims that many of the portion sizes used by the Division

---

[6]As noted above, the record in this case was closed at the conclusion of the hearing on October 10, 1995 with the exception of certain post-hearing evidence. Petitioner was given the opportunity to submit post-hearing affidavits with respect to free hors d'oeuvres, employee meals and steward sales. Petitioner submitted these affidavits along with affidavits by Jonathan Ludwig and Ellen Williams. The Division objected to the post-hearing submission of the affidavits by Mr. Ludwig and Ms. Williams on the ground that these affidavits fell outside the scope of the approved post-hearing submission and, therefore, petitioner was improperly attempting to supplement the evidence at hearing. Because the two affidavits in question discuss the serving sizes of food items, they do not constitute the category of post-hearing evidence for which permission was granted. Absent the grant of a motion to reopen the record, evidence received after the record has been closed may not be considered. Therefore, the affidavits of

were not accurate, the only portion size that was specifically disputed during testimony at the hearing was the size of the chicken servings. Petitioner requested that two and one-half pieces of chicken constituted a serving whereas the Division used one piece of chicken per serving in its calculation of the food markup. Petitioner's accountant, Mr. Venisky, testified that based on his conversations with Mr. Ludwig, the chicken portion size should be changed to 2.5 pieces per serving. Although Mr. Ludwig testified at hearing, he did not give any testimony to support Mr. Veniskey's assertions concerning the portion sizes with respect to chicken servings or other food servings. Therefore, there is insufficient evidence to justify changing the food portions used by the Division in its calculations (compare, Matter of Nina Spallina, Tax Appeals Tribunal, February 27, 1992.)

As noted in Finding of Fact "10", prior to issuing a notice of determination, the Division proposed a settlement offer that included changing the portion size of chicken to one and one-half pieces per serving. This change would have reduced the percentage markup from 193.18% to 188%. However, because petitioner did not accept this proposed settlement, the Division was not bound to change the chicken portion it used in calculating the percentage markup.

G. With respect to free hors d'oeuvres, the Division accepted petitioner's original estimation as to the value assigned to hors d'oeuvres that were provided to customers without charge. At hearing there was credible testimony by Mr. Tessoni that petitioner provided hors d'oeuvres and buffets at no charge to customers on Sundays and on days that certain sporting events were televised. Petitioner also provided one hundred and three affidavits confirming that free buffet-style food was provided on Sunday afternoons and on several occasions throughout the year. However, as noted above, these affidavits were drafted in October of 1995 and do not specify whether the free buffets were served during the audit period in question. More importantly, however, these affidavits do not give any indication as to the quantity of food served or any other indication as to a value that can be assigned to the food in order to

---

Mr. Ludwig and Ms. Williams will not be considered. Moreover, even if petitioner had moved to reopen the record for these two documents, there does not appear to be any basis for granting such motion (see, Matter of Wachsman, Tax Appeals Tribunal, November 30, 1995; Matter of Schoonover, Tax Appeals Tribunal, August 15, 1991).

determine whether the Division's acceptance of $9,100.00 per year for free food was too low. Thus, although Mr. Tessoni's testimony and the affidavits constituted credible evidence that Mr. Ludwig indeed provided free buffets regularly, there is no evidence by way of Mr. Ludwig's testimony or any other document that could establish a dollar amount warranting a change to the Division's allowance for free food which was based on petitioner's original estimates. Although the BCMS conferee referred to petitioner's subsequent adjustment of this amount from $9,100.00 for the 3-year period to $7,800.00 per year, there was no testimony or other evidence submitted to support this revised estimate.

H. With respect to Christmas gifts, Mr. Ludwig testified that he estimated that he gives away boxes of food to employees at Christmas time in the overall dollar amount of $2,000.00 per year and that he employees approximately 30 employees. Inasmuch as I find Mr. Ludwig's testimony to be credible, an adjustment in the amount of $5,500.00 for Christmas gifts should be made for the 33-month audit period. Using the Division's calculations contained in its Exhibit O, the tax liability for the period December 1, 1987 through August 31, 1990 is reduced by $743.74 ($20,388.09 - $19,644.35).

I. Petitioner has submitted affidavits from employees confirming Mr. Ludwig's testimony that he provided employees with free meals. In the affidavits, the employees stated that free meals were provided at each shift if the shift was for three hours or more. Although Mr. Ludwig provided credible testimony that the value of the meals provided was approximately $3.00 per employee and that he employed approximately 30 employees, there is no testimony or other evidence as to how many employees would be entitled to these meals during the course of a day. During the course of the discussions between the Division and petitioner prior to the issuance of the notice of determination, petitioner submitted schedules indicating that employee meals cost petitioner between $10 to $12 a day. At three dollars per employee, that amount assumes that approximately four employees are entitled to three dollars worth of meals per day. Assuming $12 a day should be allotted for free meals, this cost to petitioner would amount to approximately $360.00 per month or $11,880.00 for the 33-month period. Therefore, based on

Mr. Ludwig's testimony, the employee affidavits and petitioner's workpapers presented to the Division during the course of their discussions, an allowance should be made for employee meals in the amount of $11,880.00.

As noted by the Division, the regulations provide that food and drink furnished by an employer for his convenience to employees is subject to tax unless a money value is included in remuneration which is the basis for computing the employer's contribution to the unemployment insurance fund or a money value is assigned for social security purposes (20 NYCRR 527.8[j][1]). Because there is no record evidence to exclude the cost of the meals from tax, the money value of the meals is not exempt from sales tax; however, purchases used to provide these employee meals is also not subject to the percentage markup. Therefore, $11,880.00 worth of purchases should be excluded from the percentage markup but then added back to taxable sales. This adjustment should reduce petitioner's tax for the 33-month period by $774.88.

J. At hearing, Mr. Ludwig testified that he sold at cost unprepared food to customers. He estimated that these sales amounted to approximately $500.00 to $600.00 a month and therefore, requested an allowance for these steward sales. Prior to the issuance of the notice of determination, petitioner had asserted that steward sales amounted to $400.00 per month. In the post-hearing affidavits, fifteen individuals asserted that they purchased food items at cost from petitioner in certain amounts on an annual basis. The total annual amount indicated in these affidavits is $14,686.50. Petitioner therefore requests that an adjustment be made to purchases for steward sales in the amount of $14,686.50 per year or $40,387.88 for the 33-month audit period.

As noted in Finding of Fact "20", with the exception of one affidavit, the affidavits, which were signed in 1995, do not specify a time period for these annual purchases. Therefore, there is no basis for assuming that all these purchases were made during the audit period of December 1, 1987 through August 31, 1990. These affidavits do confirm however that Mr. Ludwig does sell at cost his food inventory to customers. Mr. Ludwig therefore provided

credible testimony that these steward sales occurred and approximated $600.00 per month or $19,800.00 for the 33-month audit period. This adjustment amounts to a reduction in tax liability of another $2,677.47 for the 33-month audit period.

K. Thus, based on all the adjustments above, petitioner's tax liability should be reduced to $16,192.00, plus penalty and interest. Similarly, the notice of determination issued to petitioner William Gleason should also be adjusted accordingly. Moreover, as noted in the conciliation order, Mr. Gleason is not responsible for any sales tax for the period after December 31, 1989.

L. Contrary to petitioner's reading of the conciliation order, the conciliation order asserting tax due in the amount of $20,090.65 was not inclusive of penalty and interest. The penalty and interest was to be calculated on that tax liability at the applicable rate. Similarly, a new penalty and interest are to be calculated on the new amount of $16,192.00.

M. Despite the fact that the Division proposed a settlement to petitioner cancelling the penalty, it has not established reasonable cause to warrant cancellation of the penalty in this forum. Tax Law § 1145(a)(1)(i) provides that any person failing to pay tax to the Tax Commission within the time required by Article 28 "shall" be subject to penalties on the amount of tax due. The Commission will remit all of the penalty if it determines that a taxpayer's failure to pay the tax in a timely manner was due to "reasonable cause and not due to willful neglect" (Tax Law § 1145[a][1][iii]; see, 20 NYCRR 536.5). The taxpayer has the burden of demonstrating that a penalty was improperly assessed (Matter of LT & B Realty Corp. v. New York State Tax Commission, 141 AD2d 185, 535 NYS2d 121, 122). In this case, petitioners' only argument appears to be that the tax was not owed. Therefore, petitioners have not demonstrated that there was reasonable cause for failure to pay the appropriate level of sales tax (see, Matter of S.H.B. Supermarkets v. Chu, 135 AD2d 1048, 522 NYS2d 985).

N. The petitions of The Humphrey House, Inc. and William Gleason are granted to the extent indicated in Conclusions of Law "E", "H", "I", "J" and "K", and are otherwise denied. The Notices of determination, dated March 1, 1993, should be modified according to Conclusions of Law "E", "H","I", "J" and "K" and otherwise are sustained.

DATED: Troy, New York
August 1, 1996

/s/ Marilyn Mann Faulkner
ADMINISTRATIVE LAW JUDGE